CHAPTER 5

OTHER MISCELLANEOUS REFORMS

This Chapter discusses proposals to reform the moving expense and income averaging provisions. The limits on moving expenses would be increased to reflect current costs. Income averaging would be modified in line with its original purposes, by denying it to persons who were full-time students during the base period.

INCREASE LIMITS ON MOVING EXPENSES

General Explanation

Chapter 5.01

Current Law

An employee or self-employed individual is allowed a deduction in computing adjusted gross income for certain moving expenses incurred in connection with the commencement of work at a new principal place of work. Direct costs of moving (costs of moving household goods and personal effects and traveling from the former residence to the new residence, including the cost of meals and lodging en route) are deductible regardless of amount, provided that they are reasonable. In addition, certain indirect costs of moving are deductible, subject to a dollar limitation. Deductible indirect costs include:

(1) temporary living expenses (for up to 30 days) at a new job location;

(2) expenses of round trip travel (including meals and lodging), after obtaining employment, from the former residence to the general location of the new principal place of work for the purpose of searching for a new residence; and

(3) certain expenses incident to a sale, purchase, or lease of a residence, such as real estate commissions and State transfer taxes.

The deduction for indirect costs is limited to $3,000, with the deduction for items (1) and (2) combined not to exceed $1,500 of the $3,000. A husband and wife who begin work at a new principal place of employment in the same general location are subject to a single $3,000 (and $1,500) limitation.

In order for moving expenses to be deductible, the taxpayer's new principal place of work must be at least 35 miles farther from his former residence than was his former principal place of work. For a taxpayer with no former principal place of work, the new principal place of work must be at least 35 miles from his former residence. In addition, the taxpayer must generally either (a) be a full-time employee for at least 39 weeks during the 12-month period immediately following arrival at the general location of the new principal place of work, or (b) perform services as an employee or self-employed individual (or both) on a full-time basis in such general location for at least 78 weeks during the 24-month period immediately following arrival at the general location (of which at least 39 weeks must be during the 12-month period immediately following arrival).

Similar rules apply to moving expenses incurred in connection with the commencement of work at a new principal place of work outside the United States. In these cases, the dollar limitation on indirect costs is $6,000, with a limit of $4,500 on items (1) and (2).

Reasons for Change

Moving expenses that are related to a change or relocation in employment are properly deductible as an expense of producing income. Available data indicates, however, that the fixed limits on indirect moving expenses are inadequate in relation to the actual costs of moving. A review of moving expense deductions in 1979 revealed that a typical taxpayer's indirect moving expenses were approaching $10,000. Inflation has since increased the level of such expenses.

Inadequate deduction limits for moving expenses increase the costs of business-related moves for either the employer or the employee. Costs for employers increase where moving expense reimbursements are increased to account for taxation of the reimbursement to the employee. The after-tax cost of moving also increases for employees who are not reimbursed and who cannot deduct all of their legitimate moving expenses. These extra costs adversely affect the mobility of the labor force and thus reduce the efficiency of the economy generally.

Proposal

The overall dollar limitation on the deduction for indirect moving expenses would be increased from $3,000 to $10,000. The dollar limitation applicable to temporary living expenses and round trip travel expenses (items (1) and (2) above) would be increased from $1,500 to $3,000.

For moves from the United States to a foreign country, the overall dollar limitation would be increased from $6,000 to $10,000, and the limitation applicable to items (1) and (2) would be increased from $4,500 to $6,000. Moves from one foreign country to another foreign country would be subject to the same limitations that apply to moves within the United States.

All dollar limitations would be subject to indexing for future inflation.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Although costs incurred for all indirect moving expenses have increased, the costs associated with the sale, purchase and rental of housing (item 3 above) have shown the most significant increases. These expenses generally are a stable percentage of the cost of housing, which has increased greatly. For this reason, the proposed increase in the dollar limitation that is applicable to such expenses is proportionately greater than the proposed increase for other indirect moving expenses.

The proposed dollar limitations are based on data on the average moving expenses incurred by employees of the Internal Revenue Service. The proposed dollar limitations generally would cover the indirect moving expenses (including real estate commissions, transfer taxes, and other transaction costs) incurred by taxpayers in connection with the transfer of an average-priced house in the United States. However, because the cost of housing varies throughout the country, the proposed limits may not cover all legitimate indirect moving expenses in some areas. In particular, the costs associated with transferring even an average-priced house is expected to exceed the limits in some high-cost areas. Larger increases in the dollar limitations, however, would cause a significant increase in the revenue loss and, more importantly, would permit taxpayers who do no not live in high-cost areas to deduct costs associated with an extremely high standard of living. Such costs are in the nature of personal expenses and should not be deductible.

The proposal to index the dollar limitations would minimize the need for periodic review of the statute.

RESTRICT INCOME AVERAGING FOR FULL-TIME STUDENTS

General Explanation

Chapter 5.02

Current Law

Because of the progressive tax rate structure, an individual whose income varies widely from year to year pays more tax over a period of years than an individual who earns comparable income evenly over the same period. The income averaging provisions mitigate this effect. Under these provisions, if an eligible individual's income for the taxable year exceeds 140 percent of his average income for the three preceding years ("base years"), the effective tax rate applicable to such excess income ("averageble income") generally will be the rate that would apply to one-fourth of the averageble income. The individual's tax liability will be an amount equal to the sum of (i) the tax on 140 percent of the three-year base period income, plus (ii) four times the extra tax from stacking one-fourth of the averageble income on top of 140 percent of base period income.

Two basic eligibility requirements restrict the availability of income averaging. First, the individual must have been a citizen or resident of the United States during the current year and each of the base years. Second, the individual (and the individual's spouse) generally must have provided at least 50 percent of his or her support during each of the three base years. This support test need not be satisfied if:

(1) the individual has attained the age of 25 and was not a full-time student during at least four years after attaining the age of 21;

(2) more than one-half of the individual's taxable income for the current year is attributable to work performed during two or more of the base years; or

(3) the individual files a joint return for the current year and not more than 25 percent of the aggregate adjusted gross income on the joint return is attributable to such individual.

In the case of an individual filing a joint return, the above requirements must be met by both the individual and the individual's spouse.

An individual who has been a full-time student during any or all of the base years is permitted to use income averaging, provided that he or she is otherwise eligible.

Reasons for Change

Income averaging is intended primarily to benefit taxpayers with widely fluctuating incomes. Under current law, however, taxpayers with sharp but sustained increases in income, typically young persons entering the job market for the first time, may qualify for income averaging and benefit substantially from it. The availability of income averaging to such persons is inconsistent with the principles of the progressive tax structure.

The availability of income averaging to individuals who were full-time students during the base period is also a source of complexity. Application of the support test to full-time students is difficult and a frequent source of contention between taxpayers and the Internal Revenue Service. The case-by-case determinations that are required represent an administrative burden and prevent any fair and consistent application of the eligibility rules.

Proposal

A taxpayer who was a full-time student in any base year would not be eligible for income averaging. This rule, however, would not apply where an individual files a joint return and 25 percent or less of the adjusted gross income reportable on the joint return is attributable to the individual. Thus, the benefits of income averaging would be available in situations where one spouse was a full-time student during one or more of the base years but had a relatively insubstantial amount of income in the current year.

In conformity with these changes, the exception to the support rule for taxpayers who are 25 years of age or older and were not full-time students during at least four of the years after they reached 21 years of age would be eliminated.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help restrict income averaging to its intended beneficiaries -- taxpayers whose incomes fluctuate widely from year to year. By reducing the number of taxpayers using the complex income averaging provisions, the proposal would simplify the tax system. The proposed flattening of the tax rate schedule also should reduce the number of taxpayers who use income averaging.